17 March 2004

Mr Tony Hinton
Presiding Commissioner
Gas Access Regime Inquiry
Productivity Commission
LB2 Collins Street East
MELBOURNE VIC 8003

Dear Mr Hinton

Response to the Issues Paper for the Review of the Gas Access Regime

Further to Enertrade's earlier submission to the Gas Access Regime Inquiry, we wish to address aspects of the Commission's draft report and to expand on our view that the gas transmission pipeline industry will flourish under a light-handed regulatory regime and will wither under the current prescriptive regime where regulators use a heavy handed building block approach to determine access tariffs and conditions. Since the current regulatory regime was put in place in 1997, there is ample evidence that the only transmission pipeline developments that have taken place are those that have been able to avoid the application of that regime. We would contend that this aspect is most important in the Commission's assessment of the loss of public benefits caused by the current regulatory regime.

Enertrade wishes to draw the Commission's attention to the fact that the recent gas supply crisis in south eastern Australian was averted only by the use of two major entrepreneurial pipelines that were built by proponents who ensured that they were not to be affected by regulation. That each of these pipelines can still be regulated under the current version of the Code remains a risk to their owners.

I look forward to discussing these important matters with you and your colleagues.

Yours sincerely

Michael Cavell
Chief Executive Officer

INTRODUCTION

Enertrade wishes to commend the Commission on its perceptive review and analysis of the Gas Pipelines Access Regime. Enertrade is pleased to be able to comment on the Commission's findings and recommendations and to expand on its earlier submission and presentation at the Commission's public hearings.

In summary, Enertrade:

- Believes that, although a two tier model of coverage can be made to work, the draft Report's recommended approach to light-handed monitoring and heavy-handed cost of service regulation has significant practical difficulties and is likely to deliver the same outcomes achieved by the current regime rather than those promoted by the Commission;

- Recommends that the two tier model consist of light handed monitoring that drives appropriate behaviour by service providers and heavy-handed cost of service regulation, the latter being imposed on service providers who, when covered by light handed monitoring, are found to have misused market power;

- Cannot accept the Commission's Draft Finding that there is no need to separate Transmission and Distribution;

- Believes that the "uneconomic to duplicate" test should be widened to address the energy market, not just the so-called "point to point" services

COMMENTS ON THE COMMISSION'S FINDINGS

Market power and regulation

Draft finding 2.1 stated, in part:

W*hile transmission pipelines have natural monopoly characteristics, the market power of transmission pipeline owners is constrained by a number of factors,*

- *the availability of substitutes — that is, the presence of a competing pipeline in the end market and/or of alternative fuel and energy sources*

- *the size and concentration of users and the competitive nature of foundation contracts*

- *the elasticity of demand for the final products, for which natural gas is an input.*

and Draft finding 2.2 stated:

While distribution networks have natural monopoly characteristics, the market power of distribution network owners is constrained by a number of factors, particularly

- *the availability of other fuel and energy substitutes. ……*
- *A network owner servicing a new market (or one in which use is low) generally has little market power.*

These draft findings would seem to imply that the Commission sees no reason to apply separate regulation to the transmission and distribution sectors. Enertrade is of the view that the strict application of cost of service regulation (at the extreme end of regulatory methods[1]) is not appropriate for gas transmission pipelines which have not been proven to have misused any market power they are purported to possess.

Transmission pipelines have little market power relative to their customers. Various contributors to the public debate on gas access regulation have made the point that most transmission pipelines have a very small number of customers – an average of 4[2] , meaning there is ample scope for negotiation between firms of equal commercial acumen and no need for involvement by a regulator. Yet, as the AGA asserts, any application of the Code to access pricing of transmission pipelines inevitably results in the regulator becoming a "proxy" for commercial negotiation[3].

While it may be that gas distribution systems need cost of service regulation as the initial step, transmission pipelines should not be so regulated - at least in the first instance - because it is practicable and efficient to apply normal commercial negotiation practices. The diagram below depicts the key differences between the allocation of economic power in gas transmission and distribution markets.

Criterion	Transmission	Distribution
Number of customers	1 – 10	1000 – 1,000,000 +
Market power and sophistication of customers	Equal to pipeline company	Significant inequality and hence must be represented by regulator
Effect on pipeline owner's revenue of loss of customer	High	Low
Attitude to customers	Focussed	Remote

[11] Productivity Commission, *Draft Report on Review of Gas Access Regime*, December 2003 p. 70
[2] Ibid, p 27
[3] Ibid, p. 70

Is the Gas Access regime working?

The Commission appears to have mixed views on whether the Gas Access regime is working. On the one hand it has suggested that the industry-specific regulation should be maintained (Draft Finding 4.1) and its implementation has lowered prices (Draft Finding 4.2) yet the Commission acknowledges that it deters and distorts investment and discourages innovation and productivity improvements (Draft Findings 4.3 and 4.4).

Enertrade believes that for gas transmission pipelines there is no need for industry specific regulation, except where there has been an irrefutable misuse of market power by the pipeline owner or operator.
In Draft Finding 4.7, the Commission has recognised that the current regime is flawed and can be improved, but again, the Commission, by linking the regulation of both transmission and distribution, has attempted to find a common solution where essential differences preclude commonality on important issues.

Objective of Regime

Referring only to gas transmission pipelines, Enertrade believes that the Objective of the Gas Access Regime should be much as the Commission recommends:

The following overarching objects clause should be inserted into the Gas Access Regime:

To promote the economically efficient use of, and investment in, the services of transmission pipelines and distribution networks, thereby promoting competition in upstream and downstream markets[4].

Enertrade remains deeply concerned that this formulation will be interpreted narrowly so that "efficient" is taken to require conditions where price equals short run marginal cost rather than focussing on long term outcomes. Also, it is not clear that the proposed construction ensures that investment must be efficient. Enertrade therefore recommends the following:

To promote the economically efficient use of, and efficient investment in, the services of transmission pipelines and distribution networks over the long term, thereby promoting competition in upstream and downstream markets.

Coverage Matters 1 - Bona Fide Access Seekers

Enertrade believes that the default position for any new or existing gas transmission pipeline should be that of no coverage. Only when a *bona fide* access seeker makes a non-trivial request for access and is denied access after a best endeavours negotiation

[4] Ibid, p. xxxvii

and capacity is available, should that access seeker be qualified to request coverage. Only in this way will the process of regulation cease to be a proxy for normal commercial negotiation. The so-called Duke case[5] was a clear example of a third party seeking coverage without seeking access.

Enertrade considers that the Commission's Draft Finding 6.9:

There might be merit in limiting coverage applications for uncovered pipelines to access seekers that demonstrate they have undertaken 'best endeavours' in commercial negotiations that failed

should become a recommendation that:

access seekers lodging access applications under the Code must demonstrate they have undertaken 'best endeavours' in commercial negotiations that failed.

Coverage Matters 2 - Test for Coverage

The Commission's Draft Recommendation 6.5 states that the first of the coverage criteria (s.1.9(a)) should be amended to include the word "material" to describe an effect of "increasing competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline". Enertrade does not believe that this will alter the NCC's recommendations on coverage matters and will lead to more, not less, disputation, since there is a misguided but firm belief that gas transmission pipeline owners will behave as monopolists merely because their assets have natural monopoly characteristics. This problem arises because of the absence of a counterfactual and suggests to Enertrade that a "behaviour monitoring" regime should be the default position.

Enertrade recommends that there be one coverage test which, if met, invokes behaviour regulation.

Enertrade in its initial submission noted a concern that "material" would prima facie set too low a threshold. This concern has been reinforced by legal advice to the Australian Pipeline Industry Association which arrives at essentially the same conclusion. In light of this, Enertrade agrees with the formulation proposed in the Australian Pipeline Industry Association's first submission which relies on "substantial". However, it is essential that "substantial" is defined in the Code and that that definition should be "large, weighty or big" or synonyms of those words. The APIA's legal advice reviews a number of decisions that considered "substantial" and in many cases the meaning attributed to it amounted to only a small degree such as "real or of substance and not insubstantial or nominal". If "substantial" were so defined under the Code then the outcome of the applied coverage test would be the opposite of the draft Report's intention. Enertrade cannot emphasise enough the need for such terms to be defined. The more economically sensible and clear the direction given by the Code to decision-makers the less the harm that will be done and the less recourse affected parties will need to have to appeal processes.

[5] Re Duke Eastern Gas Pipeline Pty Ltd [2001] A CompT 2

Enertrade also suggests that, in light of recent decision on AGL's participation in the acquisition of the Loy Yang A power station, the Commission reconsider the use of "likely" in its proposed coverage test. In that decision "likely" is taken to mean a "real chance" which is not a high threshold. The APIA's formulation addresses this concern by placing a real burden on the decision-maker to assess, and show, whether genuine benefits will arise from imposing statutory access regulation by imposing a "more likely than not" requirement rather than merely "likely". Indeed, given that transmission pipeline companies, at least, are eager for throughput and therefore do not block access unreasonably, the test ought to be strengthened further by making it clear that decision-makers are to assess whether access *under the Code* is needed to deliver the benefits sought.

Enertrade therefore recommends that the coverage test be formulated as follows:

that access under the Code (or increased access under the Code) to a Service provided by means of the Pipeline would be more likely than not to achieve a substantial increase in competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline.

Enertrade considers, and the Commission seems at times to agree, that the mere presence of natural monopoly characteristics does not mean that market power exists or that it will be abused if it does exist. At the very least, this means that the current point-to-point test at 1.9(b) of the Code must be amended to account for the broader market for energy services, including the presence of substitutes. In other words, that a pipeline has natural monopoly characteristics should not *of itself alone* be a ground for satisfying part of any test to determine a need for regulation. The fact that the regime applies to pipelines will ensure that for the great part only assets exhibiting natural monopoly characteristics are subjected to the coverage test.

Behaviour Monitoring

Enertrade does not believe that a monitoring regime imposed by the National Competition Council and administered by the relevant regulator will work. It will be intrusive and information intensive and liable to mischievous and vexatious submissions. The process will be as complicated and as drawn out as the current Access Arrangement process.

Firstly, it is doubtful that the Code or the Pipelines Access Law can be drafted sufficiently clearly to allow the NCC to determine with certainty which pipelines should be monitored and those that should be regulated. In these circumstances the NCC will recommend regulation.

Secondly, it will be impossible to define the monitoring criteria without reference to "efficient costs", which will lead to the current difficulties with the cost of service tariff determination. That is, regardless of whether it is the National Competition Council or the regulator setting the information requirements, the relevant decision maker will require service providers to provide the same data required of entities subject to cost of service regulation. The regulator will then examine whether a monitored entity is

charging prices that would prevail under cost of service regulation or higher prices. If higher prices are being charged it will be assumed the entity has and is misusing market power and therefore must be subjected to cost of service regulation.

The NCC has acted along these lines previously, notably when considering APT's application to revoke coverage of the Moomba to Sydney pipeline. The NCC's consultants, despite the introduction of Duke's Eastern Gas Pipeline, mis-used "efficient cost" analysis to claim that APT was acting monopolistically by charging 65c/GJ when the ACCC thought the price should be 49c/GJ. In light of such experience, Enertrade is sceptical of proposals to give any decision-maker the capacity to decide what information should be provided to regulators because of the high likelihood it will used to further the regulatory agenda rather than the spirit of the access regime.[6]

Thirdly, the monitoring process will do little to encourage pipeline owners and operators to develop pipeline services that meet specific customers' needs.

Finally, the prospect of an intrusive and costly monitoring arrangement leading inevitably to price regulation will do nothing to redress the current circumstances where investment in pipelines is being inhibited[7].

Enertrade proposes that the monitoring process would be much better managed if they were to be done in the manner developed by Duke for the Eastern and Tasmanian Gas Pipelines and being proposed by Enertrade for its North Queensland Pipeline. This behaviour monitoring process includes:

1. An expectation that the transmission pipeline will not be regulated;

2. The existence of a foundation contract that underpins some of the investment and sets prices such that they provide encouragement for market growth and competition between upstream producers and in downstream markets;

3. Publication by the pipeline owner of a document that sets out principles of non-discrimination, access, service offerings, prices, dispute resolution processes, capacity trading mechanisms, expansions and extensions policy and terms and conditions of standard contracts;

4. A process that ensures that all the relevant details of contracts with associated entities are made public and an undertaking that all those terms and conditions must made available to any other bona fide pipeline user that requires a materially equivalent service;

5. An annual process whereby an external auditor determines whether the pipeline owner has complied with both the spirit and content of the access principles.

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[6] Ordover, J A and Lehr, W, *Should Coverage of the Moomba-Sydney Pipeline be Revoked?*, November 2001.

[7] Draft finding 4.3 "The Gas Access Regime deters and distorts investment…."Productivity Commission, *Draft Report on Review of Gas Access Regime*, December 2003

The results of the audit would be published at the same time as an annual financial report;

6. A process for redressing shortcomings revealed by the audit.

7. Dispute resolution, ultimately through an independent arbitrator (that is, not a regulator under the Code).

This regime will set up points at which the behaviour of service providers can be assessed on the basis of their actions, that is on facts. If a service provider is found by the audit to have made a significant breach or breaches of these conditions that cannot be redressed, for example by restitution, then it may be that it is misusing market power. Similarly, if the service provider fails to abide by the determination of an independent dispute arbitrator then it may be that it is misusing market power. If such a case is made successfully then the service provider should be subjected to cost of service regulation.

Enertrade considers that the application of such a monitoring arrangement as the initial form of coverage will be the most effective mechanism for determining whether market power is being abused and therefore whether intrusive regulation is required. Other approaches to deciding whether intrusive regulation is warranted are essentially speculative and therefore unacceptably prone to errors that could lead to overall economic losses. Enertrade would be pleased to expand on this approach at the Commission's public hearings in late March 2004.

Appeals

Enertrade strongly supports the draft Report's recommendations on appeals under the Regime.

In principle, appeals form an essential accountability tool in any legislative regime giving administrative decision-makers considerable discretion to affect the interests of a natural person or a business. In practise, the record of Gas Access Regime-related cases determined by the Australian Competition Tribunal on appeal demonstrates that decision-makers can make serious errors that need to be redressed. In light of principle and experience, changing the Code to restrict appeal rights under the Gas Access Regime will damage the confidence of investors in government's concern for their interests and exacerbate the economic distortions caused by the Regime. On the other hand, changes along the lines recommended by the Commission will increase the rigour of decisions made under the Code.

DEALING WITH ASSOCIATES OR AFFILIATES

In its draft report the Commission stated:

Further, the Commission does not consider that the transparency of affiliate transactions alone would be sufficient incentive for a service provider not to favour its affiliates. The model suggested by Duke Energy International and APIA — whereby the

service provider would be required to offer external parties the same terms and conditions offered to affiliates — would overcome this problem.

However, as discussed in chapter 8, non-discriminatory pricing might be inefficient, so the Commission does not consider it appropriate to prescribe such an approach.

Further, under a non-discriminatory policy, access seekers have no flexibility in terms and conditions if they want to gain access at the price that the service provider offers its affiliates.

Enertrade cannot agree with the Commission's last statement but accepts that in strict economic terms, non-discriminatory pricing can be "inefficient".

Enertrade's method of dealing with affiliate contracts and application of non-discriminatory pricing incorporates:

- publishing key contract details of all affiliate contracts, including prices, term (length of contract) and payment arrangements
- a perpetual undertaking to offer materially equivalent terms to any other customer, including the right of any customer to change its contract to reflect the affiliate's terms
- a published set of conditions for determining material equivalence
- an annual audit of Enertrade's behaviour in compliance with these terms.

Note that Enertrade's non-discriminatory pricing policy does not extend to contract term – that is, the longer the term the lower the price.

Enertrade recognises that non-discriminatory pricing can be economically inefficient, in that one cannot apply pricing based on incremental load. However, this problem can be overcome to an extent by offering discounts for a defined period for new short term contracts.

1.1 Ring fencing

Enertrade stands by its earlier statement that ring fencing cannot be applied practically in a corporate environment because at some point in the chain of command of a corporation there is a requirement for one person to take overall responsibility for corporate behaviour and strategy. This person is most likely to be the Managing Director of the holding company. Most gas transmission pipeline companies and their gas trading entities have only a few staff, so it is inevitable that there are several key company officers who, for good corporate governance and risk management reasons must know and act on price setting for the pipeline entity and gas sales and purchases for the trading entity.

As a result, and from practical experience by Enertrade's Chief Executive Officer, Enertrade believes that the section of the Code that deals with ring fencing is unworkable for transmission pipeline companies and their gas trading affiliates.

Enertrade is able to understand the concern expressed by gas retailers using distribution networks owned by affiliates of competing retailers. In these cases, unless

strict confidentiality provisions are in place, the implementation of full retail contestability can be damaged by leakage of information. However, Enertrade contends that it is almost impossible for adequate ring fencing to be applied in the light of demands by corporate regulators for good corporate governance and continuous disclosure by listed companies. This is a matter the Commission should address in the light of its Draft Finding 10.1:

The ring fencing and associate contract provisions of the Gas Code are warranted and are important for an effective regulatory regime. They do not appear to have involved inappropriate costs.

Enertrade believes that the Commission's Draft Recommendation 10.1 will not satisfy the concerns of competing retailers and major network customers:

Section 7.1 of the Gas Code should be amended such that a service provider entering an associate contract for the supply of services at the reference tariff must notify the relevant regulator, but is not required to seek authorisation.

While this requirement will allow the regulator to review the contract, it gives the regulator no power to amend or cancel the associate contract and does not provide any information or reassurance to the market that the contract is fair and reasonable. Enertrade and Duke's transparency of process and non-discrimination policy overcome all of these issues.